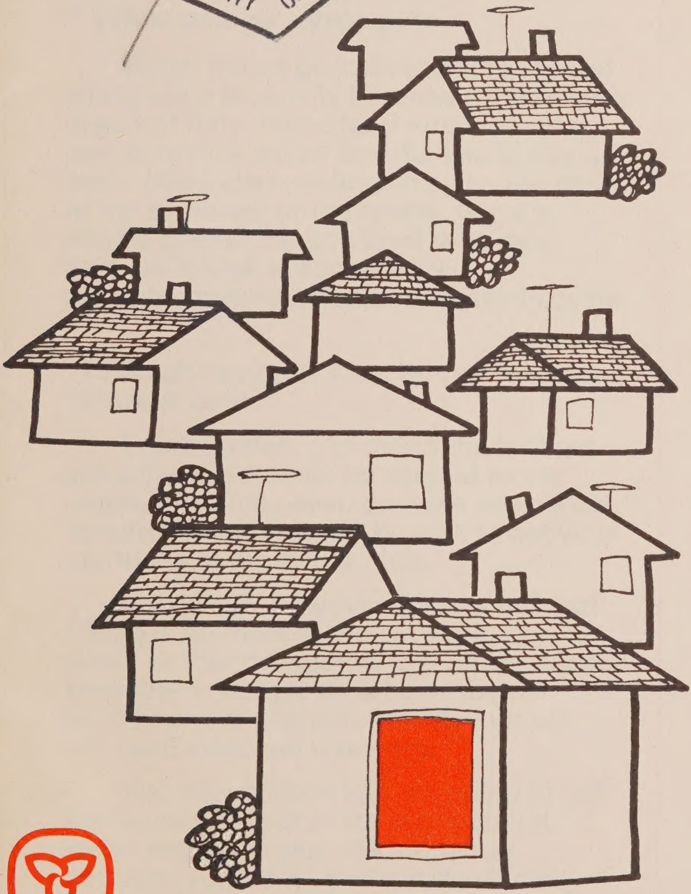
Getting a Second Mortgage



Ontario

Ministry of Consumer and Commercial Relations

Getting a Second Mortgage

A second mortgage may be the best way to get the house you want or to raise urgently needed money. But handled unwisely, a second mortgage can be a major source of financial difficulty for the average Canadian family. You could even lose the house you have worked and saved for. To prevent this, you will need to ask questions and use caution.

"What can go wrong?"

When things go wrong with a second mortgage it is usually because the borrower does not fully understand what the total cost is or how much time he has to pay it back. Misunderstandings may be the fault of the borrower or the lender, but it is almost always the borrower who gets hurt. Let's look at some of the common misunderstandings that can occur.

"I can always get that advertised low interest rate."

Some lenders and mortgage brokers advertise lower rates for second mortgages. They may even promise you on the telephone that you will be able to get your mortgage at these low rates.

Very often, however, it turns out that "there is no more money at the lower rates" or that the special low rates are only available to people who have such a solid financial position that they would not need a second mortgage.

You may believe you are going to get the lower rate, but at the last moment, when you go to sign the mortgage contract, you could find out it will cost you much more. The extra cost may ruin all your plans.

"Is he a lender or a broker?"

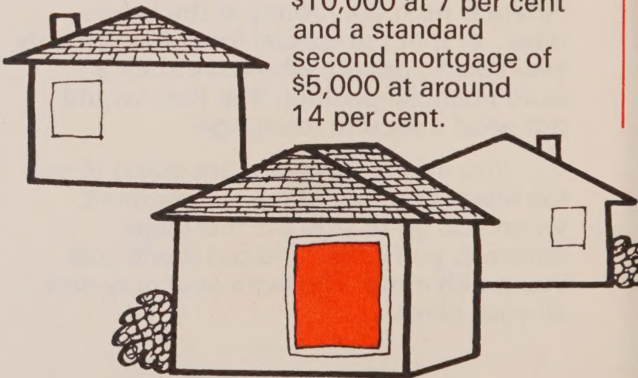
Second mortgage funds are available from credit unions, loan companies and private lenders, who lend their money directly to individuals. Banks and trust companies may also be able to make arrangements for you to get a second mortgage. Mortgage brokers operate differently. They are middlemen who get money for you from institutions or private lenders and then lend it to you, adding on their own brokerage fee as an extra expense.

Some of these mortgage brokers have company names that give the impression that they are large corporations lending their own funds. Find out if he is a lender or a broker.

"Instead of a second mortgage, why not a bigger first mortgage?"

Be very careful here. Let's suppose you have $10,000 left to pay on your first mortgage, which is at 7 per cent. Let's also suppose you need $5,000 and you are thinking of a second mortgage.

The lender or broker may suggest that instead of having two payments — one for the first mortgage and one for the second — you should just have one payment for a new, larger first mortgage. He might suggest, for example, a new first mortgage of $15,000 at 12 per cent, instead of your existing first mortgage of $10,000 at 7 per cent and a standard second mortgage of $5,000 at around 14 per cent.



Stop and think. If you keep your 7 per cent mortgage and take the second mortgage, your total interest payments during the next year would be $1,400*. If you take the new first mortgage, the interest will cost you $1,800* next year.

So don't give up that lower interest first mortgage unless you are really going to get a better deal. Refinancing your home this way can be disastrous.

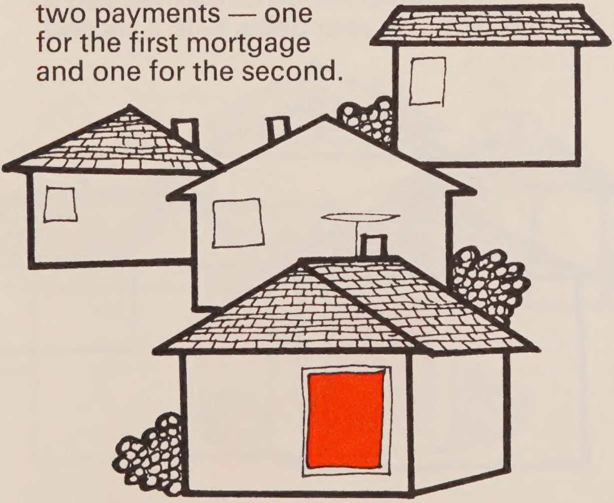
(*Not counting any decrease in total interest charges due to repayment of part of the mortgage.)

"Can't I get a second mortgage that will cover my first mortgage too?"

Yes, you can. It's called a blanket mortgage. This is where things can really get complicated and great caution is needed.

Let's suppose you have a $30,000 house, and $20,000 to pay off on the first mortgage at 8 per cent. You need $5,000 and you have heard that you can get a homeowner's loan on a second mortgage basis.

The lender tells you that you can have the $5,000 second mortgage you want at 15 per cent but that you will need to make two payments — one for the first mortgage and one for the second.



As an alternative, the lender may suggest that you can turn the $20,000 first mortgage over to him and he will pay it off for you. In its place he will give you one large second mortgage covering the total amount at, say 12 per cent. This is a "blanket" mortgage.

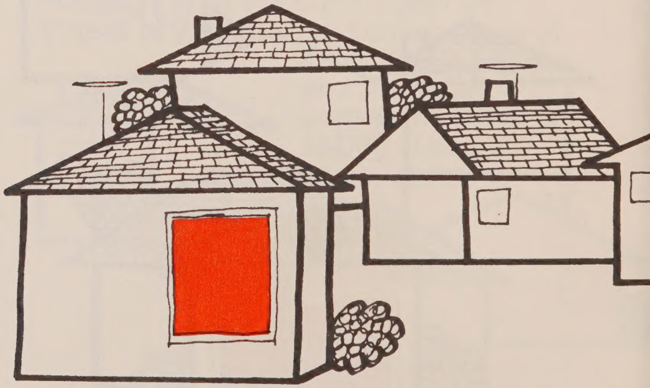
Taking the blanket mortgage means you will then have a new mortgage for the combined amount of $25,000 at 12 per cent — this $25,000 being the amount of your first mortgage plus the $5,000 you wanted in the first place.

It all seems so easy. But what you may not realize is that you now have $45,000 in debt on your $30,000 house — the new $25,000 mortgage and the old $20,000 mortgage that is still being paid off by the lender. The interest payments are now $3,000 for the next year rather than $1,600 and the effective rate of interest on the $5,000 you borrowed is 28 per cent. That kind of interest rate is simply far too high.

"Why not take out a second mortgage so I can consolidate my debts?"

It depends upon what your debts are and how much interest you are paying.

Some advertisements may tell you to consolidate all your debts with a second

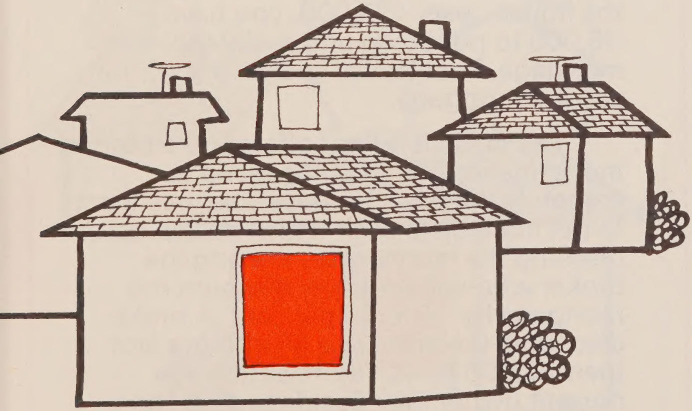


mortgage so that you are left with only one monthly payment smaller in total than the combined monthly payments you were paying before. Sometimes this is a good idea. But it doesn't work every time.

Let's think it through. Consolidating your debts with a second mortgage can be cheaper only if the interest rate on the mortgage is lower than the interest on the other debts you want to consolidate.

But that's not all to watch for. Just because the interest rate or the size of the monthly payment is lower doesn't mean you will end up paying less. You may have a smaller monthly payment or a slightly lower interest rate but the repayment may extend over a longer period of time, making the total interest charges more expensive in the long run. Or, you may make smaller monthly payments, but get left with a very large payment at the end of the mortgage.

Don't just look on the surface. Figure out the total interest on your present debts if you pay them off over a reasonable period of time and then compare that with the total interest you will pay on the second mortgage. Insist upon getting this comparison straight before you make a decision on a second mortgage.



"Why not get a second mortgage to pay for our holiday? I can pay it off with next year's bonus."

Business may look good this year, but can you count on next year? If things don't work out as you plan, you could even lose your house.

This danger is especially great with the so-called "balloon payment". A low monthly payment can be arranged on the second mortgage, as if you were going to take 10 or 20 years to repay. But the mortgage is usually up after only 5 years, leaving the borrower with a very large final payment (the balloon payment).

That's fine if your bonus comes through, but if it doesn't ,you may need to refinance on short notice. This can be very expensive and may even be impossible, depending upon your overall financial position. You could lose your house.

"I'm buying a house. Isn't it easier to get a second mortgage from the present owner?"

It could be, but it might also be more expensive. You may find that the cost of the house goes up, because the second mortgage is discounted.

This is how it works. Let's suppose the house costs $30,000, you have $5,000 to put down and a $20,000 first mortgage. That leaves you with a $5,000 second mortgage.

The present owner offers you a second mortgage for the $5,000 needed to complete the deal. However, he may want to get immediate cash which he can do by reselling the mortgage to a mortgage broker who will probably discount the mortgage by 15 to 20 per cent. A broker discounts the mortgage by offering less than $5,000 for it. To offset this, the present owner may decide to pass the

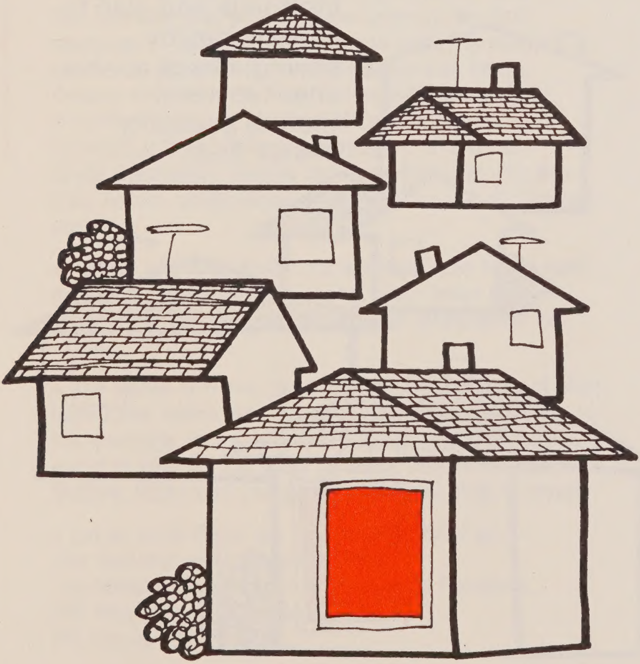
discount on to you, by selling you a $6,000 second mortgage that he can then resell to the mortgage broker at the discount to get his $5,000.

The result is that the house has gone up $1,000 in price. Instead of having a second mortgage of $5,000 at, say, 15 per cent, you now have a $6,000 mortgage at 15 per cent, which is equivalent to ending up with the original $5,000 mortgage at 18 per cent.

In this particular case, you would probably be much better off to go directly to a mortgage lender or broker in the first place. However, if the present owner would rather keep the second mortgage and collect the interest himself as investment income, it may be the best deal.

"Can't I save money by using the lender's lawyer?"

You should want a lawyer who is thinking of your own interests, not the lender's interests.



"Second mortgage rates are all about the same, aren't they?"

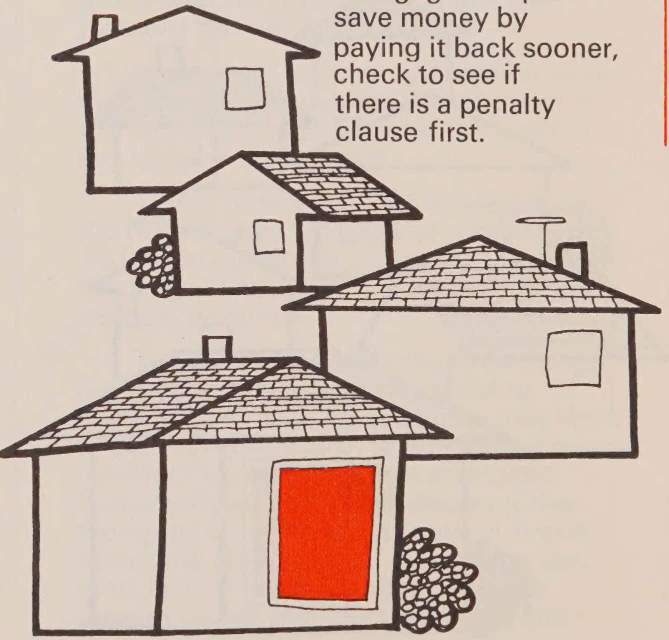
No, they are not. If the total amount of your first and second mortgage is less than 75 per cent of the appraised value of your house, the second mortgage should be at the same rate as the first mortgage or just slightly higher. The more of your own money you have in the house, the lower your second mortgage interest rate should be.

If you have little money of your own invested in the house, a second mortgage rate varies according to your income and your credit rating.

"If I pay off my second mortgage fast, it will cost me less."

Perhaps. But it may not. Your mortgage may have a penalty clause if you try to pay it off faster than the scheduled rate of repayment.

If you are getting a five year second mortgage and plan to save money by paying it back sooner, check to see if there is a penalty clause first.



How to get it right

There are several basic steps you can take to make sure your second mortgage is right for you.

- Always use your own lawyer. It really is worth it.

- Try to deal directly with a lending institution such as a bank, or trust company. They may be able to offer you a new first mortgage with an interest rate lower than the combined rate on your present first mortgage plus a new second mortgage. They may also be able to help you get a second mortgage at the best available interest rate and with fewer additional charges.
If you need to use a mortgage broker, find out his total fee in advance. Shop around.

- Don't use a second mortgage to pay off debts that do not have interest charges. Deal directly with the people that you owe money but who are not charging you interest and arrange a repayment schedule with them.

- Try to avoid borrowing against your house with a second mortgage to buy consumer items or to pay off consumer debts. Keep it as an asset in case of real need. It's not a good idea to put your house in a vulnerable position. Better to have a washing machine repossessed than your house.

- Don't refinance your house at high interest rates so that you lose your present lower interest rate first mortgage. If debts are pressing you hard, you should consult an expert before you refinance your house. Contact the Social Services Consulting Branch of the Province of Ontario, Ministry of Community and Social Services at Queen's Park to determine if there is a Credit Counselling Service near you. They can give you free, honest, professional advice on your overall financial position.

- Always add in all brokerage and legal fees to the total cost of the house you are buying. Don't leave yourself short at the last moment because you forgot about the extras.

- The lender or broker must give you a Statement of Mortgage Form, which sets out clearly the important points of the mortgage contract, at least 24 hours before you are asked to sign the mortgage contract. This is the law in Ontario. Make sure you get this form and study it closely.

- Let us know if you get into trouble. Write to: —
The Registrar of Mortgage Brokers,
The Ministry of Consumer & Commercial Relations,
555 Yonge Street, Toronto, Ontario.
We may be able to help.